Supreme Court U. S.
FILED
FEB 26 1976
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975.

No. 75-1065

JOHN NUVEEN & CO., INC., A CORPORATION, INVESTORS SYNDICATE OF AMERICA, INC., A CORPORATION, AND INVESTORS DIVERSIFIED SERVICES, INC., A CORPORATION,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

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Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

Respondent respectfully submits that the Petition for a Writ of Certiorari should be denied since the decision below does not conflict with decisions of this Court, there is no conflict of decisions among the Circuit Courts of Appeals on any issue decided by the Court below, and the decision below is correct.

OPINIONS BELOW.

The opinions and orders below are described in the Petition, and are reprinted in the Appendix to the Petition.

JURISDICTION.

The jurisdictional requisites are adequately set forth in the Petition.

QUESTIONS PRESENTED.

1. Are non-prime, short-term notes sold in small denominations to the public for investment purposes subject to the provisions of the Securities Exchange Act of 1934?

2. Is an underwriter and exclusive seller of non-prime, short-term notes sold to the public in small denominations and subsequently dishonored liable to purchasers to whom the underwriter sold the notes for failure to make a reasonable investigation of the issuer?

3. May an underwriter of the sale of securities subject to the Federal Securities Acts reasonably and properly rely upon financial statements of the issuer made by auditors whom the underwriter does not know, has never met, and does not meet, and where the underwriter has not examined any corporate records, contracts or income tax returns of the issuer?

4. May an underwriter reasonably and properly rely on financial statements of an issuer of securities when the auditor expressly states that its opinion is based upon comments which show serious deficiencies in the auditor's examination of the issuer?

5. Is an underwriter-dealer in short-term notes liable under § 12(2) of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder to its purchasers for failing to state to the purchasers that the notes bear an inferior credit rating and for making misrepresentations of material facts concerning the notes?

STATUTES AND RULES INVOLVED.

The statutes and rules involved are set forth in the Petition, p. 3, and in the Appendix to the Petition, A. 69-77, with the exception of Rule 27 of Article III of the Rules of Fair Practice of the National Association of Securities Dealers, Inc., which is set forth in the Appendix hereto, A1.

STATEMENT OF THE CASE.

The facts in this case are set forth at length in the Findings of Fact entered by the District Court. A. 20-40. Among the salient facts not appearing in the Petition are the following.

Prior to acquisition of Ashwell & Company in September, 1968, John Nuveen & Co., Inc. ("Nuveen") had never sold short-term notes. From September 1, 1968 to February 10, 1970, Nuveen was the exclusive seller of notes issued by Winter & Hirsch, Inc. ("WH"). From January 1, 1969 to the time Nuveen ceased to sell WH notes it made approximately 275 sales of such securities with a face value of $9,305,500.

Nuveen made no examination or credit investigation of any issuer prior to the time Nuveen commenced to sell the notes of that issuer. None of the notes sold by Nuveen was rated "Prime" by the National Credit Office ("NCO"). Nuveen had no requirement that the financial statements of companies whose notes it sold must be certified by a certified public accountant. Nuveen's personnel checked the credit of issuers of notes by analyzing the financial statements sent to them by the issuers, by reading NCO reports and by addressing credit inquiries to banks. The replies from banks neither showed the financial strength of an issuer, nor constituted a credit evaluation.

Nuveen never employed more than one credit investigator and for various periods had no credit investigator in its commercial paper department even though Nuveen sold notes issued by 40 to 50 different companies at any one time. At such times the head of the commercial paper department assumed credit checking duties. Nuveen's last commercial paper department head testified he was too busy to check credit.

One Nuveen credit investigator made on-site inspections of issuers. In March, 1969 he made a one-day visit to the offices of WH. He did not examine any internal control or accounting records, or corporate records. He testified he "most likely did"

examine WH's federal tax returns because it was his practice to do so. The 1968 WH federal tax return showed a loss of $955,000, while the 1968 audit report WH had sent to Nuveen showed a profit of $499,119.09 before provisions of $244,000 for income taxes for the year. The beginning balance sheet on the 1968 tax return did not agree with the ending balance sheet on the 1967 return.

Nuveen had no written policies or directives with reference to commercial paper.

In late December, 1969, the new head of Nuveen's commercial paper department had lunch with the President of WH, noted that he looked ill, and ordered Nuveen's credit investigator to do a credit report on WH. The investigator, who relied solely on WH's latest audit report, prepared a report in which WH notes were rated "Desirable" rather than "Prime", although Nuveen had no system for rating commercial paper. Ten days after that report the investigator sent credit inquiries on WH to a dozen banks. Nearly a month after the credit report an executive of one of the banks telephoned the head of Nuveen's commercial paper department and gave him information which led to the discovery by Nuveen that various banks had initiated an investigation of WH in December, 1969, and that an independent audit of WH had been commenced in early January, 1970. Nuveen then suspended the sale of WH notes.

REASONS FOR DENYING THE PETITION.

I. It Is Settled Law That Non-Prime, Short-Term Notes Sold To the Public for Investment Purposes Are Securities Subject to the Federal Securities Acts.

Petitioners are attempting to obtain review not only of the last decision in this case but also of an earlier decision that resulted from certification of a controlling question of law by the trial court.

In the earlier appeal it was held that the short-term notes issued by WH and sold by Nuveen were securities subject to the proscriptions of § 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and Rule 10b-5, 17 CFR § 240. 10b-5. *Sanders* v. *John Nuveen & Co., Inc.*, 463 F. 2d 1075 (7th Cir. 1972), *cert. denied*, 409 U. S. 1009 (1972). (*Sanders I*, A. 49-62.) The question whether the notes here involved are securities as defined in § 3(a)(10) of the Securities Exchange Act of 1934, 15 U. S. C. § 78c(a)(10), was certified for immediate appeal by the District Judge under 28 U. S. C. § 1292 (b) as "a controlling question of law" in order to "materially advance the ultimate termination of the litigation." A. 66. The Court of Appeals accepted the interlocutory appeal and answered the certified question affirmatively. This Court denied certiorari and the case was remanded for trial. Voluminous discovery was taken and after a full trial the District Court found for respondent and the represented class. A. 20-48. On appeal the judgment entered by the District Court was affirmed. *Sanders* v. *John Nuveen & Co., Inc.*, 524 F. 2d 1054 (7th Cir. 1975). (*Sanders II*, A. 1-19.)

Although the Court of Appeals in *Sanders II* refused the request of petitioners to reconsider its holding in *Sanders I* (A. 6, n. 8), petitioners argue here that the Court of Appeals "reaffirmed its position after development of a complete record," and contend "the matter is now ripe for resolution by this Court."

Petition, p. 9, f.n. Should this Court grant certiorari and reverse *Sanders I* certification will have resulted in a large and wasteful expenditure of time and energy by the judiciary and the litigants.

Sanders I was correctly decided and has been widely followed. It is now settled law that the crucial distinction between notes subject to the anti-fraud provisions of the securities acts and those which are not is whether the transaction underlying the issuance of the note has a commercial character or whether the note was purchased for the purpose of investment. The date of maturity of the note is not meaningful to that distinction. While *Sanders I* was not the first decision to enunciate the investment/commercial dichotomy in determining whether notes are exempt securities,[1] *Sanders I* has become the wellspring of a fountain of decisions adopting and following that rationale. Expressly following *Sanders I* are *Zabriskie* v. *Lewis*, 507 F. 2d 546 (10th Cir. 1974); *SEC* v. *Continental Commodities Corp.* 497 F. 2d 516 (5th Cir. 1973); *Zeller* v. *Bogue Electric Manufacturing Corp.*, 476, F. 2d 795 (2d Cir. 1973), *cert. denied*, 414 U. S. 908 (1973); and *The Franklin Savings Bank* v. *Levy*, CCH Sec. L. Rep. 95,389, at p. 78,961 *et seq.* (Current Binder) (S. D. N. Y. 12/29/75). See also *Smith* v. *Manausa*, 385 F. Supp. 443, 448 (E. D. Ky. 1974); and *Welch* v. *Goldman, Sachs & Co.*, 398 F. Supp. 1393, 1396-8 (S. D. N. Y. 1974). In each of the foregoing cases the Court ruled that the notes involved were investment securities. In numerous decisions in which the Court ruled that notes were *not* investment securities and were exempt from the anti-fraud provisions of the 1934 Act, *Sanders I* is cited with approval, and the note involved is analyzed in accordance with the *Sanders I* rationale. See *C. N. S. Enterprises, Inc.* v. *G. & G. Enterprises, Inc.*, 508 F. 2d 1354,

1. See *Joseph* v. *Norman's Health Club*, 336 F. Supp. 307, 313 (E. D. Mo. 1971); *United States* v. *Hill*, 298 F. Supp. 1221, 1226-1227 (D. Conn. 1969); *Anderson* v. *Francis I. duPont & Co.*, 291 F. Supp. 705, 707-709 (D. Minn. 1968); *City National Bank of Fort Smith, Ark.* v. *Vanderboom*, 290 F. Supp. 592, 608 (W. D. Ark. 1968), *aff'd*, 422 F. 2d 221 (8th Cir. 1970), *cert. denied*, 399 U. S. 905 (1970).

1356 *et seq.* (7th Cir. 1975), *cert. denied* 96 S. Ct. 38 (1975); *Bellah* v. *First National Bank*, 495 F. 2d 1109, 1111 (5th Cir. 1974); *McClure* v. *First National Bank*, 497 F. 2d 490, 493 (5th Cir. 1974), *cert. denied*, 420 U. S. 930 (1975). See Lipton and Katz, "'Notes' Are Not Always Securities," 30 Bus. Lawyer 763 *et seq.* (April, 1975), in which numerous District Court decisions holding short-term notes to be either investment or commercial securities are discussed. In *Lino* v. *City Investing*, 487 F. 2d 689 (3d Cir. 1973), the court analyzed notes issued for the purpose of purchasing assets of a business as commercial notes, rather than investment securities, and thus exempt from the application of the federal securities acts.

The great majority of the decisions cited above, including *Sanders I*, rely in great part upon the opinions of this Court which call for a flexible and broad interpretation of the word "security", and emphasize that in this field form should be disregarded for substance and economic reality. *Tcherepnin* v. *Knight*, 389 U. S. 332 (1967); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180 (1963); *SEC* v. *W. J. Howey Co.*, 328 U. S. 293 (1946); *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943). This Court reaffirmed the principle of liberal and sensible interpretation of the term "security" in *United Housing Foundation, Inc.* v. *Forman*, ... U. S. ....., 95 S. Ct. 2051, 2058 *et seq.* (1975). In holding in *Forman* that shares of stock in a nonprofit housing cooperative were not "securities" within the purview of the 1933 and 1934 Acts, this Court cited *C. N. S.*, *McClure* and *Lino*, 95 S. Ct. at 2059, n. 13, in support of its determination that a literal approach to the definition of "security" was improper.

The enormous amount of commercial paper outstanding recounted by petitioners in their *ad terrorem* argument, Petition, 11, points up the need for protection of the investing public in the sale of "commercial paper". Stocks and bonds are also sold in great quantities. Nevertheless, both the securities industry and the economy have prospered even though the sale of such secur-

ities has been subject to the restrictions of the federal securities acts.

The decision petitioners here seek to review concerns only notes issued in relatively small denominations and sold to the public.[2] Presumably all such investment paper is now being registered with the SEC before being sold to the public, and the underwriters distributing and selling that paper are subject to the absolute liability provisions of the 1933 Act, as well as to the anti-fraud provisions of the 1933 and 1934 Acts.[3]

In the instant case it was clearly demonstrated in the record that the notes issued by WH and sold by Nuveen were sold to the public for investment purposes and were "securities" within the application of Rule 10b-5.

II. The Decision Below Properly Holds Petitioners Liable for Nuveen's Failure to Make a Reasonable Investigation of Winter & Hirsch, Inc.

While petitioners concede that Nuveen is an underwriter as defined in the 1933 Act (assuming WH notes are 'securities'), they nevertheless argue that Nuveen should not be held to the duties of an underwriter. Petition, 18, f.n. Petitioners and the

2. Thirty of the forty-three purchasers of notes dishonored by WH and sold by Nuveen were individuals. They purchased in denominations as low as $1,000.

3. The SEC has disapproved the sale of unregistered short-term notes to the public in denominations as high as a minimum of $10,000. Texas American Bancshares, Inc., letter available 9/3/74; Central Service Corp., 1973 CCH Sec. L. Dec. ¶ 79,460. Sale of short-term notes in lower minimum denominations without registration has been disapproved by the SEC. Real-Tex Enterprises, Inc., 1972-73 CCH Sec. L. Dec. ¶ 78,813; Neil Stephens Associates, Inc., letter available 1/9/74. Where notes in much larger denominations were advertised for sale to the public the SEC has disapproved sale without registration. American Automobile Insurance Brokers, Inc., letters available 7/19/74 and 6/24/74. The SEC has required a dealer in commercial paper to determine whether the security must be registered. *SEC* v. *Goldman, Sachs & Co.* (consent decree arising out of sale of Penn Central notes), CCH Fed. Sec. L. Rep. ¶ 94,556 (S. D. N. Y. 1974).

amici curiae do not object, however, to being held to the standards of a broker-dealer.[4]

Petitioners contend that because no registration statement was filed covering the sale of the notes here at issue § 11 of the 1933 Act is inapplicable. The standard of duty of an underwriter of securities is spelled out in § 11 of the 1933 Act, petitioners' argument continues, and therefore Nuveen cannot be held to that standard in an action brought under § 10(b) of the 1934 Act.

The objective of judicial decision-making in the securities field has been to effectuate the Congressional intent of protecting the investing public. *S. E. C.* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1973). In light of that objective it would be ironic if the underwriter could lessen his liabilities under the securities acts by avoiding the duties imposed by those acts. The decision of the Court below is based on testimony that Nuveen sold short-term notes on the basis "that there should be no question but what the paper will be paid at maturity." A. 2, 33. The sale of securities on that basis "enhanced the importance of determining the basic integrity of the issuer's financial statements." A. 9. The Court below properly implemented the statutory structure of the securities acts by holding that the distribution and sale of non-exempt securities by an underwriter who fails to make a reasonable investigation of the issuer is a "device, scheme or artifice to defraud," or an "act, practice or course of business which operates or would operate as a fraud or deceit upon any person . . ."[5] Rule 10b-5.

4. The *amici*, apparently feeling themselves free of the positions taken below by the parties, argue that the Court below erroneously characterized Nuveen as an underwriter. On oral argument before the Court of Appeals petitioners conceded that if the WH notes were securities Nuveen was an underwriter. Respondent, with the agreement of petitioners, and by leave of the Court below, has caused a portion of the oral argument below to be transcribed and transmitted to this Court. The relevant colloquy is set forth in the Appendix hereto, A2.

5. "Fraud" and "deceit" as used in § 10b and Rule 10b-5 are not to be equated with the common-law cause of action for fraud, or

(*Continued on next page*)

The Court below looked to the entire statutory scheme and the context of the transaction in weighing the proper application of the 1934 Act. A. 9. In order for an underwriter to sell notes on the basis that they will be paid when due, it must make a reasonable investigation to determine whether the issuer's financial statements possess any integrity. The underwriter should at least determine whether an audit in fact has been made. On the other hand, in the context of the sale of short-term securities, the validity of long-range projections and future business prospects have little significance; the underwriter should not be liable under Rule 10b-5 for a failure to investigate such projections and prospects.

Petitioners contend that if the burden of reasonable investigation of the issuer is placed upon underwriters of commercial paper that financing instrument will be destroyed. Undoubtedly many corporations, underwriters and broker-dealers flocked to the short-term note in order to avoid the expense and burden of registration with the SEC. And, as with other types of securities, numerous defalcations have occurred among issuers of commercial paper.[6] However, the great bulk of commercial

(Continued from preceding page)

the classic tort of deceit. *Blue Chip Stamps, et al.* v. *Manor Drug Stores,* 421 U. S. 723 (1975); *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U. S. 180, 194 (1963).

6. Among the companies that have dishonored their commercial paper are the following. Atlantic Acceptance Corporation, Ltd., see "Report of Atlantic Acceptance Urges Sweeping Rule Changes", N. Y. Times, 12/12/69, p. 89, col. 5; Pioneer Finance Co. ($3 million in commercial paper), see "Pioneer Finance; 'Tight Money' Claims A Casualty", N. Y. Times 9/26/66, p. 63, col. 3; Mill Factors Corporation ($6.7 millions of commercial paper) "Heavy, Heavy . . .", Forbes, 8/15/71", p. 21, "Financial Collapse and Human Tragedy Stalk Mill Factors," N. Y. Times 4/23/69, p. 71, col. 1; Penn Central Transportation Company ($85 million of commercial paper), see Staff Report of the SEC to the Special Subcommittee on Investigations, Committee on Interstate and Freight Commerce, The Financial Collapse of the Penn Central Company (August, 1972); Beverly Hills Bancorporation ($13 millions of commercial paper), see "Bancorp on Coast Reveals Problems", N. Y. Times,

(Continued on next page)

paper is prime paper eligible for discount with the Federal Reserve Bank and is exempt both from the registration and anti-fraud provisions of the 1933 and 1934 Acts. Non-prime commercial paper sold to the public in small denominations through underwriters and dealers on an investment basis is not and should not be exempt from either the registration or anti-fraud provisions. The need of the public for protection from fraud in the sale of such paper is not less than the need for such protection in the sale and distribution to the public of any other type of security. The burgeoning of the market for commercial paper is not an argument for lowering the statutory shield of protection for the investing public.

Contrary to the fears of petitioners and *amici curiae,* the Court below specifically immunized underwriters from the obligations of a guarantor. "Although the underwriter cannot be a guarantor of the soundness of any issue, he may not give it his implied stamp of approval without having a reasonable basis for concluding that the issue is sound." A. 9-10. If the proper examination is made by the underwriter the dishonored notes will not become his obligation.

Nor does the decision below contravene any ruling or expression of this Court in *Blue Chip Stamps.* The reading of *Blue Chip Stamps* by petitioners distorts and misapplies that decision. *Blue Chip Stamps* concerns standing of a plaintiff to sue under § 10(b) or Rule 10b-5, not standards of liability under that section or Rule. There this Court expressly stated: "Blue Chip did not here present the question of whether an implied action under § 10(b) of the 1934 Act and Rule 10b-5 will lie for actions made a violation of the 1933 Act and the subject of express civil remedies under the 1933 Act. We therefore have no occasion to pass on this issue." (citations omitted) 421 U. S. at 752, n. 15.

(Continued from preceding page)

12/31/73, p. 27, col. 7; Franklin N. Y. Corporation, see N. Y. Times, 1/13/75, p. 44 col. 7. Many of these defalcations are discussed in Note, The Commercial Paper Market and the Securities Act, 39 U. Chi. L. Rev. 362, at 378 (1972).

Foremost-McKesson, Inc. v. *Provident Securities Co.*, 44 U. S. L. W. 4056 (January 13, 1976), also relied on by petitioners, deals with the question of standing to sue under § 16(b) of the 1934 Act—a section which imposes absolute liability for violation of its provisions. Determination of liability under § 10(b) and Rule 10b-5 is not reasonably susceptible to the type of absolute treatment applied in *Foremost-McKesson*. Determination of the identity of those a statute is designed to protect involves considerations different in kind from a determination of the conduct the statute prohibits, especially in construing language such as "manipulative or deceptive device or contrivance . . ."

The cases applying § 14 of the 1934 Act, 15 U. S. C. § 78n (proxy violation), are more to the point in the construction of analogous sections of the securities laws than the cases construing § 16(b). In the decision below it is pointed out that in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F. 2d 341, 370 (2d Cir. 1973), *cert. denied*, 414 U. S. 910 (1973), the standards for underwriters expressed in the 1933 Act were used as a guide to determine the liability of an underwriter in a case arising under § 14 of the 1934 Act. A. 8, n.

The decision below is one of reason and common sense, and it is firmly grounded in the statutory scheme of the 1933 and 1934 Acts. Rule 10b-5 was expressly designed to cover the scheme or device that does not fit neatly within the technical provisions of the 1933 Act but which nevertheless operates to deprive the investing public of its protections.

To hold an underwriter liable under Rule 10b-5 for failure to make a reasonable investigation of the issuer is not to imply remedies where none are expressed, but to apply recognized standards of conduct in situations where those standards are necessary for the protection of the investing public.

III. Issues of Scienter and Negligence Are Irrelevant To the Standard of Liability Employed by the Court Below.

Petitioners argue that under Rule 10b-5 there can be no liability without scienter, and proof of negligence is not enough.

Respondent believes the position of petitioners on the need for proof of scienter in a Rule 10b-5 cause of action is erroneous. Petitioners invoke war cries that have long been stilled.[7] More to the point, however, those issues simply are not relevant to the decision below.

Petitioners presumptively anticipate the decision of this Court in *Ernst & Ernst* v. *Hochfelder*, 503 F. 2d 1100 (7th Cir. 1974), *cert. granted*, 421 U. S. 909 (1975) (No. 74-1042), and pray this Court grant the writ and reverse summarily if the Court should require a showing of scienter in that case. That prayer is far-fetched. First, the issue in *Hochfelder* is whether Ernst & Ernst is liable as an aider and abettor of a violator of Rule 10b-5, not whether Ernst & Ernst was a direct perpetrator of a securities act violation in the context of particular transactions. Ernst & Ernst did not sell securities to anyone. Respondent and the members of the represented class purchased their notes directly from Nuveen. In *Hochfelder* there is no nexus of a transaction between Ernst & Ernst and a plaintiff; in this case there is complete privity.

In the securities acts Congress has made the extent of liability imposed upon a participant in a securities transaction dependent

7. Among recent cases holding that specific intent to deceive is not necessary to establish liability under § 10(b) are *Rochez Bros., Inc.* v. *Rhoades*, 491 F. 2d 402, 407-8 (3d Cir. 1974); *Cohen* v. *Franchard Corp.*, 478 F. 2d 115, 123 (2d Cir. 1973), *cert. denied*, 414 U. S. 857 (1973); *Globus* v. *Law Research Service, Inc.*, 418 F. 2d 1276, 1291 (2d Cir. 1969), *cert. denied*, 397 U. S. 913 (1970); *Shapiro* v. *Merrill Lynch*, 495 F. 2d 228, 238-9 (2d Cir. 1974); *Johns Hopkins University* v. *Hutton*, 326 F. Supp. 250, 256 (D. Md. 1971), *aff'd in part and rev'd in part*, 488 F. 2d 912 (4th Cir. 1973), *cert. denied*, 416 U. S. 916 (1974); *Tomera* v. *Galt*, 511 F. 2d 504 (7th Cir. 1975).

upon the culpability of the unlawful conduct and the relationship between the defendant and the transaction that resulted in the plaintiff's injury. The standards of liability range from absolute liability to subtle gradations of negligence. The more direct the relationship, the lesser the culpability required for liability.

The bold assertion that if this Court rules scienter a requirement of proof in *Hochfelder* then this case should be summarily reversed is to swing a very broad axe indeed. A ruling that an aider and abettor must have an intent to deceive has little applicability to the fact situation in this case.

IV. The Decision Below Does Not Enlarge the Statutory Duties of an Underwriter.

Petitioners say that the decision below requires the underwriter to verify the accuracy of the report of an expert such as an independent public accountant. Nothing in the decision below supports that assertion. Underwriters customarily do and must have face-to-face meetings with auditors. In the situations examined by the courts in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F. 2d 341 (2d Cir. 1973), *Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E. D. N. Y. 1971); and *Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 (S. D. N. Y. 1968), the underwriters involved each had face-to-face ("due diligence") sessions with the issuer's accountants. Textbooks, manuals and guidelines for underwriters routinely call for such face-to-face sessions.[8] The purpose of these meetings is for the underwriters to determine that the auditor really exists and is competent and independent, and has done his job.

In the instant case the so-called "work papers" of Lieber, Bleiweis were one-half inch thick. A glance at these work papers would have made it known that no audit of WH had

8. See PLI Securities Law Institute—II, The Review of Securities Regulation, 975-77 (V. 7, No. 3, Feb. 6, 1974).

been performed by Lieber, Bleiweis. That was only one of several steps that, if taken, would have uncovered WH's fraud, or raised suspicions which mandated further investigation. Respondent believes that is the correct reading of the decision below on this point.

Nuveen "most likely" did not examine the federal tax returns of WH, although that was Nuveen's accepted procedure. The last two federal tax returns filed by WH did not correspond at all to the audited statements WH sent to Nuveen for those years. Nuveen did not cause the corporate records or contracts of WH to be examined. The corporate records had not been maintained since 1966.

Certainly on these facts the decision below cannot be read as an expansion of the hitherto defined duties of an underwriter.

V. The Decision Sought To Be Reviewed May Be Sustained on Several Grounds Not Reached by the Court of Appeals.

In reaching its decision the Court below assumed or accepted several arguments and contentions advanced by petitioners. If this case is to be reviewed respondent contends that the finding of liability and the judgment entered below may be sustained on grounds not relied on by the Court of Appeals, or on one issue not resolved by the trial court. The judgment of the trial court may be sustained on any ground that is supported in the record. *Jaffke* v. *Dunham*, 352 U. S. 280 (1957).

A. The Lieber, Bleiweis Audit of Winter & Hirsch, Inc. Was Uncertified, or at Best Qualified in Such Manner That Nuveen Could Not Reasonably Have Relied on It.

In checking the creditworthiness of WH Nuveen relied primarily upon annual and semi-annual audit reports which WH sent to it. Those audit reports were completely fictitious and bore no relationship to WH's books and records or to WH's federal income tax returns.

The audit reports were so unusual or peculiar that Nuveen could not reasonably and properly rely on them. Respondent contends and the last credit investigator employed by Nuveen testified that the Lieber, Bleiweis audit reports of WH were uncertified. At best they were qualified audit reports.

Thus a serious question exists in this case as to whether Nuveen met the standard of an underwriter, a broker-dealer, or simply that of a reasonable investor is relying on the audit reports. No one in this case has yet contended that a seller of securities has no obligation of any kind to his buyers. The federal securities acts substitute a policy of full disclosure to investors for the philosophy of *caveat emptor* in the sale of securities. *Affiliated Ute Citizens* v. *U. S.*, 406 U. S. 128,153-4, *reh. denied*, 407 U. S. 916, 408 U. S. 931 (1972).

B. Petitioners Are Liable To Respondent and the Class Represented by Respondent for Nuveen's Failure To Comply with Rule 27 of the National Association of Securities Dealers.

Rule 27 of the National Association of Securities Dealers ("NASD") requires that a securities dealer adopt and promulgate written procedures to be followed in selling securities, and to properly supervise its salesmen. The rules of the NASD were promulgated pursuant to § 15A of the 1934 Act, 15 U. S. C. § 78o-3. Violation of those rules provides a basis for private damage actions. *SEC* v. *First Securities Company of Chicago*, 463 F. 2d 981 (7th Cir. 1972) *cert. denied sub nom. McKy* v. *Hochfelder*, 409 U. S. 880 (1972). Nuveen failed to establish, maintain and enforce written procedures for the sale of investment securities, or properly to supervise the salesmen employed by it in the sale of the short-term notes here at issue, and is liable for that failure.

C. Nuveen Misrepresented WH Commercial Paper and Omitted To State Material Facts Necessary To Make the Statements Made Not Misleading in Violation of Section 12(2) of the 1933 Act, Section 10(b) of the 1934 Act, and Rule 10b-5.

Respondent proved direct misrepresentations made by Nuveen salesmen to various members of the class in connection with the sale of WH notes to them. In addition, Nuveen did not communicate to purchasers of WH notes the fact that those notes were only rated "desirable" rather than "prime" and were more speculative with greater attendant risks than prime paper. That was an omission to state a material fact necessary to make the statements made not misleading.

Should the writ of certiorari issue, respondent will request this Court to sustain the judgment for respondent and the members of the class on the ground that the misstatements of and omissions to state material facts in connection with the sale of WH notes to respondent and the represented class are violations of § 12(2) of the 1933 Act as well as of § 10(b) of the 1934 Act and Rule 10b-5.

CONCLUSION.

Respondent prays that the Petition For A Writ Of Certiorari be denied.

Respectfully submitted,

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APPENDIX TO BRIEF FOR RESPONDENT IN OPPOSITION.

RULE 27 OF ARTICLE III OF THE RULES OF FAIR PRACTICE OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

SUPERVISION.

Written procedures.

(a) Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.

Responsibility of member.

(b) Final responsibility for proper supervision shall rest with the member. The member shall designate a partner, officer or manager in each office of supervisory jurisdiction, including the main office, to carry out the written supervisory procedures. A copy of such procedures shall be kept in each such office.

Written approval.

(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

Review of activities and annual inspection.

(d) Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses and at least an annual inspection of each office of supervisory jurisdiction.

Qualifications investigated.

(e) Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications and experience of any person prior to making such a certification in the application of such person for registration with this Association.

Office of supervisory jurisdiction.

(f) "Office of supervisory jurisdiction" means any office designated as directly responsible for the review of the activities of registered representatives or associated persons in such office and/or in other offices of the member.

EXCERPTS FROM ORAL ARGUMENT BEFORE THE UNITED STATES COURT OF APPEALS.

Mr. Horwich (for Defendants-Appellants): "This case deals with the question of the responsibility of a broker-dealer selling commercial paper. It pertains to a class action brought by approximately 43 class members against the broker-dealer and alleged controlling persons in connection with the sale of commercial paper of a small consumer finance company, Winter & Hirsch. . . .

". . . There is a separate basic issue on each of the two appeals. The basic issue on the first appeal from the basic judgment in favor of the class against the defendants is whether a broker-dealer selling commercial paper has a responsibility to discover a joint fraud conducted by the issuer and the issuer's auditor."

The Court: "Do you dispute the fact that the broker-dealer is an underwriter?"

Mr. Horwich: "I do not. I think that under Section 2(11) Nuveen was probably a statutory underwriter."

The Court: "Probably, or do you agree that he was an underwriter?"

Mr. Horwich: "I would agree."

The Court: "You don't challenge that conclusion of law?"

Mr. Horwich: "No, but I do not think that that affects the standard of liability that is placed on Nuveen in this situation."

The Court: "Is that an issue, though, whether it does? They argue otherwise, I think, on that."

Mr. Horwich: "Yes, they do, your Honor. But we believe that the principal provision on which the District Court relied —plaintiffs relied—Section 11—has no application to this case for several primary reasons. The first one is—there is no registration statement here."

The Court: "I understand that, but do you agree that even if the case is simply a 10b-5 case, the standard of care for an underwriter is the same as the standard of care for a broker-dealer?"

Mr. Horwich: "If it's an underwriter outside the context of Section 11, I don't believe that there is any difference in the standard. I think whether or not it's a statutory underwriter is really immaterial in determining the standard there."